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SUBJECT: US Treasury Meetings in Greece: Despite Credibility Gap, Chances of Near-Term Default Slim

REF: A. ATHENS 2192; B. ATHENS 1705; C. ATHENS 1653

SUMMARY

¶1. (SBU) In December 18 and 21 meetings in Athens with visiting Treasury Representative for Europe Mathew Haarsager, Greek government and bank officials expressed the common view that the main challenge facing the GoG was undertaking a reform program that would restore credibility in Greek economic policy-making with the EU, markets, and ratings agencies. The Minister of Finance and others at the Finance Ministry seemed to be placing all of their eggs in the basket of an updated Stability and Growth Program (SGP), which is to be submitted to the EU in January. They promised that all concerns would be addressed by the SGP, which will catalogue the GoG's medium-term reform program and include concrete, quantifiable measures they hope the EU and markets will endorse. With mere weeks to go before the submittal of the SGP, however, few Finance officials could provide details. Private bank officials were more critical of the GoG's actions to date, noting they would like to see the GoG take decisive actions that have a more immediate impact on the budget deficit and thereby restore market confidence. They expressed frustration that their access to capital markets was tightening as a result of the GoG's inability or unwillingness to deal with its deteriorating public finances. Nonetheless, the consensus view - perhaps hope -- by most was that the GoG would provide an adequate reform program in the SGP, the EU would accept it, and Greece's negative slide in the markets would cease. Most regarded the possibility of a Greek sovereign default as negligible in the near-term. In terms of the banking sector, most felt it was well capitalized and very liquid, but there were concerns about how the continuing slowdown of the Greek economy and the tightening of ECB liquidity measures by the end of 2010 would impact bank balance sheets. END SUMMARY.

MINISTER OF FINANCE

¶2. (SBU) On December 21, Minister of Finance George Papakonstantinou underscored to the Ambassador and the Treasury rep that the main challenge for Greece at this juncture is to convince the markets that the GoG is taking the measures necessary to restore discipline to public finances and begin reducing its 12.7 percent deficit (2009 projection). The goal is to reduce the deficit by 4 percent in 2010 (to 8.7 percent) through a 50/50 combination of revenue-enhancing and expenditure-cutting measures included in the budget passed on December 23 and as announced by the Prime Minister on December 14 (see reftels A and B). By 2013, the GoG hopes to reduce the deficit to below 3 percent as a result of these measures and an overhaul of the tax and budgeting systems

(see reftel C). The Minister stressed, however, that implementing these reforms will take time; the big question is whether markets will be patient. The Minister expressed frustration with what he saw happening in the markets, including the shorting of Greek sovereign bonds and international ratings agency downgrades - steps he felt were unjustified and which could hasten the very result (i.e., default) all were working to avoid. While Greece's debt dynamics are bad, the increase in debt as a percent of GDP since 2007 has been less in Greece than other countries in Europe, the Minister stated. [Note: During 2007-2011, Greece's debt to GDP is expected to rise by almost 40 percent, while Ireland's is expected to rise by over 70 percent. End Note.] He stressed that the only factor that made Greece unique, compared to other countries in the EMU or EU with high deficits and exploding debt like Ireland and the United Kingdom, was the credibility gap resulting from unfulfilled prior reform promises and unreliable statistics.

¶3. (SBU) According to Papakonstantinou, Greek officials understand they need show the markets immediate positive reform momentum in order to gain time to implement longer-term reforms that will overcome their credibility gap. To this end, the Minister intends to provide a steady flow of information on GoG reform efforts to EU leaders, markets, ratings agencies, and the financial press. As a result of his recent flurry of meetings and briefings in European

capitals, he believes there is now a better understanding of the GoG's reform plan and resolve. Markets and the EU now understand, according to the Minister, that despite the fact that the GoG has resisted pressure to follow Ireland's lead and cut public sector wages, measures the GoG is taking will be equally painful and result in cutting the public sector wage bill. [Note: Chairman of the Greek Council of Economic Advisors George Zanias on December 29 subsequently clarified for DepEconCouns that the plan to reduce public sector entitlements by 10 percent will impact one-third of the wage bill and result in a 3-4 percent nominal wage cut. Given next year's 1.4 percent expectation for inflation in Greece, this nominal cut translates to about a 5 percent real cut in wages. According to Zanias, Moody's analysts highlighted that this was a higher real cut than that recently undertaken by Ireland, which he believes was around 2.5 percent given Irish deflation. The SGP to be submitted to the EU in January will give these and further details on the GoG's measures. End Note.]

¶4. (SBU) Papakonstantinou nonetheless admitted that markets still want to see immediate concrete measures and results. More importantly, they want to see the GoG stand up to domestic opposition to the implementation of reforms. Although Papakonstantinou did not specify what the EU wants to see, he believes the EU's goal is to continue to talk tough and keep up pressure on Greece to implement reforms. The minute the EU starts talking about the need for a bailout, however, Greece would be "killed" in the markets. In terms of an IMF program, all understood Greece could not go out of the Eurozone framework. But, Papakonstantinou hedged, there is also a realization that a Eurozone country can default, and the EU or the IMF would need to provide support should such a situation arise.

OTHER FINANCE MINISTRY OFFICIALS

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¶5. (SBU) In separate meetings with Elias Plaskovitis, the Finance Ministry's lead Secretary General (December 21), and Elias Pentazos, Secretary General for Fiscal Policy and the General Accounting Office (December 18), each SecGen explained to the Treasury rep and DepEconCouns the GoG's intention to include greater detail on its reform efforts in the SGP. With mere weeks to go before submission, however, neither SecGen seemed able to brief on specifics of what would be in this plan. SecGen

Plaskovitis explained the content would be similar to that provided by Ireland and other countries, and it would include "specific, quantified measures." Asked what the markets want to see in the SGP, Plaskovitis responded that one investor told the Minister during his European capital briefing tour that markets wanted to see "blood running" as a result of reforms. They want to sense that the GoG it taking painful measures, despite public opposition. Plaskovitis stressed that EU support for the SGP will provide a strong signal to investors and markets. To this end, the GoG is cooperating with the EU in drafting the SGP to ensure that the SGP is received positively.

¶6. (SBU) SecGen Pentazos explained that his part of the Ministry is focused on developing a database to track public sector salaries - a key step in beginning to control the public sector wage bill. He also explained that beginning in January, his office would begin taking a stronger and more active role in budget execution, through monthly monitoring of each ministry's budget to ensure ministries do not overspend as they have done historically. In contrast to similar efforts taken by previous governments, Pentazos argued, PM Papandreou has made it clear to all Ministers they are to abide by the new rules. Pentazos stressed that the PM is committed to moving forward quickly to convince markets that Greece has a credible reform plan. While he knows there will be clashes with certain groups, including public sector labor unions, he stressed the PM would not waiver. He stated that external pressure could be useful in providing leverage to the GoG as it takes on difficult reforms.

¶7. (SBU) On December 21, Public Debt Management Agency (PDMA, part

of the Finance Ministry) Director General Spyros Papanicolaou expressed his belief that the financial media overblown concerns about Greece. As an example, he cited the Financial Times cover story of S&P's downgrade of Greece as the type of story that in normal times would not have made it to the front page. He understood that this heightened attention is due to implications for the common currency and the viability of the Eurozone project itself, but he believes the media is overdoing it; in his view, bankruptcy is out of the question. Papanicolaou agreed that the main challenge facing the GoG is bridging the credibility deficit. He asserted, however, that this government is committed to implementing reforms, despite the fact that some within the PASOK government are opposed to taking some reforms (i.e., like cutting wages). He argued that the probability of default in the next 1-2 years is zero as the markets would continue to lend Greece money since Greece will work with the EU on implementing SGP measures, and the EU will monitor Greece's performance on a quarterly basis under the Enhanced Deficit Procedure (EDP). According to Papanicolaou, the GoG's borrowing needs in 2010 will be EUR53-55 billion, EUR9-11 billion less than the amount borrowed in 2009. This is made up of EUR31 billion in redemptions and EUR24 billion in deficit financing. While Greek banks financed 55-60 percent of the GoG's borrowing program through the Spring of 2009, by summertime this percentage had gone down, and the DirGen expects this support to go down even more in 2010 because of the unwinding of ECB liquidity measures.

CENTRAL BANK

¶8. (SBU) On December 18, officials at the Bank of Greece, Greece's central bank, including Panagiotis Thomopoulos, Member of the Monetary Policy Council and former Deputy Governor Bank of Greece; Isaac Sabethai, the Director of the Economic Research Department; Nicholas Tsaveas, the Director of the Financial Stability Department; and Ioannis Gousios, the Director of the Bank Supervision Department, underscored that the challenges facing

Greece are immense and range from lack of competitiveness to chronic poor public finance management that have contributed to Greece's twin debt and current account deficits. That said, it is BG staff's assessment that the GoG is being sincere in its efforts and is committed to taking a series of bold reforms over the next few months that countries usually undertake over the course of several years. They assessed that that the public, ultimately, would accept the necessity of reforms because of the tenuous position in which Greece finds itself. BG staff also regarded external pressure from the EU, the IMF, and others as helpful in keeping the GoG's resolve strong and providing the government with a scapegoat to gain public acquiescence.

¶9. (SBU) BG staff indicated that they are urging domestic banks to find alternative financing sources to the ECB liquidity measures, which they fully expect to be unwound by the end of December 2010. [Note: Greek banks have been among the heaviest borrowers from the ECB, with a combined EUR47 billion (down from EUR53 billion during the summer) drawn from the ECB's special liquidity window (out of EUR650-680 billion of total assets accepted by the ECB), which was opened to help Europe's banks overcome a shortage in liquidity stemming from the financial crisis. Greek banks have been playing the carry trade by borrowing from the ECB and then investing in Greek government bonds - borrowing low and lending high. As the ECB scales back this facility and GoG debt becomes more expensive or no longer accepted as collateral at the ECB as a result of low credit ratings, excessive ECB financing on Greek bank balance sheets could impair banks' capital and liquidity positions. End Note.] According to BG staff, Greek banks are already scaling back their use of the ECB liquidity facilities at the BG's urging. By the end of 2010, the BG would like to see ECB financing on Greek bank balance sheets reduced to EUR10-15 billion, which is still higher than pre-crisis levels. BG staff does not believe this will have a significant impact on the GoG's ability to finance itself in 2010, as Greek banks provide little financing to the GoG relative to foreign markets. Even absent this deleveraging by Greek banks, the GoG would have needed to find foreign buyers for its debt. BG staff believe foreign markets will continue to lend to the GoG, as Greece is still a member of the EMU; Greek debt will continue to pay high returns in return for low risk.

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¶10. (SBU) Overall, BG staff assert Greek banks are well capitalized, that the quality of capital is high, and that their liquidity is good. The following data was provided by the Financial Stability and Bank Supervision Departments:

Liquidity Risk - loan/deposit ratio:

End-Sept. 2009   End-Dec. 2008

Greece/foreign subsidiaries: 113%
115%

Greece only:
105%   109%

Capital Adequacy Ratios:

End-Sept. 2009   End-Dec. 2008

CAR, Greece/foreign subsidiaries: 11.7%
9.4%

CAR, Greece only: 13.2%
10.7%

Tier 1, Greece/foreign subsidiaries: 10.7%

7.9%

Tier 1, Greece only: 11.7%
8.7%

BG staff feel credit risk in Greece may be rising, with non-performing loan (NPLs) rising to 7.2 percent in Greece at the end of September 2009, from 5 percent at the end of 2008. While stock of provisions has increased, the coverage ratio of NPLs by provisions has decreased significantly to 41.9 percent (September 2009) from 48.9 percent at the end of 2008. BG staff note that further deterioration of Greek banks' loan portfolios in Greece may be possible, depending on the length and impact of the economic slowdown.

PRIVATE BANKS: EUROBANK & NATIONAL BANK OF GREECE

¶11. (SBU) On December 18, Eurobank Deputy CEO Nikolaos Karamouzis stated Greece's debt dynamics were out of control. He noted that the markets have not yet bought the PM's reform measures, and the next 60 days will be crucial for the GoG to regain confidence via concrete, measurable actions. As a result of Greek sovereign debt on Greek banks' balance sheets and worries over how slow growth will affect NPLs, Karamouzis admitted that Greek banks no longer have access to senior debt markets. In his opinion, the GoG needs to "overreact" with measures in order to regain market credibility. Despite Greek banks being very liquid and well capitalized, Karamouzies opined that Greek banks will be under severe pressure if Moody's downgrades to a BBB+ (as Fitch and S&P have done). Karamouzis stated that if Greece is locked out of capital markets, Greek banks will not be able to finance Greek debt alone. Finally, he noted that tough talk by external voices like the EU is useful in keeping pressure on the GoG to implement reforms.

¶12. (SBU) Echoing comments made by BG staff and Karamouzis, Eurobank General Manager Fokion Karavias stated that Greek banks are well capitalized and have good liquidity. The key risks for banks as the Greek economy and Greek public finances continue to

deteriorate are two-fold: (1) increased credit risk as NPLS rise; and (2) liquidity pressures due to ECB financing on Greek bank balance sheets. In order to mitigate these risks, the GoG needs to spell out concrete measures in the SGP that will have an immediate effect on the budget deficit and market confidence. He explained that markets are looking for more painful expenditure cuts because these will have a more immediate impact on the budget deficit than plans to raise revenues. Markets are also looking for strong, positive endorsements of the forthcoming SGP from the EU as a result of Greece's "credibility deficit." If the EU endorses the SGP, markets will give Greece time to implement the measures; if the EU does not, Karavias opined, markets will create the conditions of ECB tightening before the end of 2010, which could hasten the need for an EU or IMF bailout package. He explained the impact on banks in either scenario will depend on how depositors react; a bank run could occur if there is prolonged uncertainty about the GoG's ability and willingness to implement reforms (e.g, GoG equivocation in the face of prolonged labor union protests, lukewarm market or EU reaction to SGP, etc.). Karavias believes , however, that this government, with its 160-seat majority in Parliament, both understands the seriousness of the situation and has the political will to undertake tough reforms. While it will be difficult, he believes the economic situation is reversible. As such, he does not fear that markets will stop purchasing Greek debt, and he expects that the ECB will continue to accept Greek bonds as collateral. Finally, as others have noted, Karavias believes outside pressure can continue to induce the GoG to take

the right actions.

¶13. (SBU) On December 21, Paul Mylonas, Chief Economist and Chief of Strategy for the National Bank of Greece (NBG), Greece's largest commercial bank, noted that only actions that represent significant political cost to the GoG will restore market confidence in Greece, provided the GoG faces down any opposition. Mylonas opined that while continued tough talk by the ECB and the EU can be useful, markets will continue to provide liquidity to Greece because (1) it will remain an EU and EMU member with at least a tacit guarantee of a bailout; (2) the chances of default are low, and the returns on Greek sovereign bonds high; and (3) it is generally difficult for a public entity to go bankrupt (e.g., Argentina). Mylonas believes, however, that the GoG will need to find additional external creditors in 2010, since Greek banks will be unable to provide as much financing as they did in 2009 (as a result of pressure by the BG to move away from ECB financing). On the domestic banking sector, Mylonas indicated that the market liquidity that slowly came back in 2009 is once again gone for Greek banks as a result of the GoG's debt and ratings. NBG is trying to adjust by issuing a series of short-term bonds. Mylonas noted that any reduction in customer bank deposits (and there has been some noise by high-end, large customers) will impact NBG's balance sheet. He further opined that if Moody's cuts Greece's rating to a BBB+ and the ECB scales back its liquidity measures, NBG will need to find new sources of financing to cover collateral it has used to get low-interest loans from the ECB. NBG recently announced it plans to pay back EUR2.5 billion in ECB loans early next year, bringing its outstanding ECB borrowings down to EUR11 billion.

COMMENT

¶14. (SBU) Part of the GoG's reluctance to be more clear on its reform measures may be intentional, given its desire to avoid provoking a strong reaction from labor unions and other domestic opponents of reform. It also may be due to continued infighting within the government between those who favor additional cuts, including to public sector wages, and those with populist tendencies who favor additional handouts to mitigate the social impact of the economic slowdown. Following his recent tour of European capitals, it is clear the Minister understands that markets want to see positive momentum on reforms and, more importantly, more budget cuts included in the SGP. Less clear, however, is whether the GoG will include such measures, and how the EU and markets will react if they do not. END COMMENT.
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